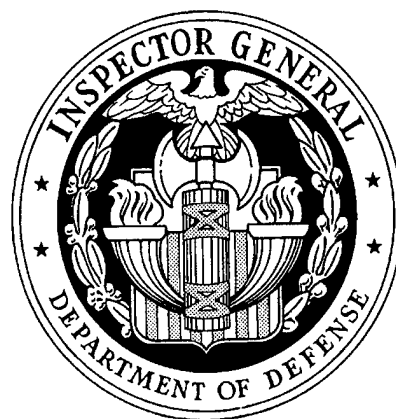


Audit



Report



RESULTS OF THE DEFENSE LOGISTICS AGENCY
STRATEGIC SUPPLIER ALLIANCE FOR CATALOG ITEMS

Report No. D-2000-192

September 29, 2000

This special version of the report has been revised
To omit data considered "Honeywell Proprietary"

Office of the Inspector General
Department of Defense

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Acronyms

CAS	Cost Accounting Standard
DCAA	Defense Contract Audit Agency
DCMA	Defense Contract Management Agency
DLA	Defense Logistics Agency
DORRA	Defense Operations Research and Resource Analysis
DSCR	Defense Supply Center Richmond
FAR	Federal Acquisition Regulation
NSN	National Stock Number
RIT	Rapid Improvement Team



**INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884**

September 29, 2000

**MEMORANDUM FOR UNDER SECRETARY OF DEFENSE FOR ACQUISITION,
TECHNOLOGY, AND LOGISTICS
DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY
DIRECTOR, DEFENSE LOGISTICS AGENCY**

**SUBJECT: Report on the Results of the Defense Logistics Agency Strategic Supplier
Alliance for Catalog Items (Report No. D-2000-192)**

We are providing this redacted audit report for public release. No written response to this report was required, and none was received. We provided the For Official Use Only version of the report to Honeywell International, Incorporated, for its comments on information that could be company confidential or proprietary. Honeywell comments were considered in preparing the redacted report for public release.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Terry L. McKinney at (703) 604-9288 (DSN 664-9288) (tmckinney@dodig.osd.mil) or Mr. Henry F. Kleinknecht at (703) 604-9324 (DSN 664-9324) (hkleinknecht@dodig.osd.mil). See Appendix D for the report distribution. The audit team members are listed inside the back cover.

Robert J. Lieberman
Assistant Inspector General
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Office of the Inspector General, DoD

Report No. D-2000-192
(Project No. D1999CF-0077)

September 29, 2000

Results of the Defense Logistics Agency Strategic Supplier Alliance for Catalog Items

Executive Summary

Introduction. Over the past 4 years, the Office of the Inspector General, DoD, has worked closely with the Defense Logistics Agency (DLA) and other DoD Components to achieve fair pricing for sole-source items. We have issued a series of reports involving pricing of both commercial and noncommercial spare parts. Two of the reports addressed sole-source commercial and noncommercial spare parts procured from AlliedSignal Incorporated. In June 1999, (in response to the reports) the Director, DLA and the Deputy Under Secretary of Defense (Acquisition Reform) chartered a rapid improvement team for the development of a new "Strategic Supplier Alliance" relationship between DLA and AlliedSignal. Instead of placing spare parts into either commercial or noncommercial categories, the DLA-AlliedSignal strategic supplier alliance segregated the sole-source spare parts into three distinct purchasing environments: catalog, replenishment, and rapid build-to-order. Each purchasing environment was designed to satisfy different customer needs and demands by fully leveraging customer buying power and taking advantage of the capabilities of both the supplier and DLA. In December 1999, AlliedSignal, Incorporated, and Honeywell, Incorporated, merged forming a new company, Honeywell International, Incorporated (Honeywell).

Objectives. The overall objective of this review was to analyze spare parts in the "catalog" and "replenishment" purchasing environments to identify key users and potential impediments and cost reductions associated with using these different environments to procure spare parts. Specific objectives focused on determining current logistics response times, stock levels, and potential cost reductions associated with shifting from the current method of support to a more tailored approach.

Results. This report addresses the results achieved by the rapid improvement team and the award of the strategic supplier alliance contract with Honeywell for catalog items. Two future contracts will be awarded for replenishment and rapid build-to-order items as part of the alliance and a subsequent report will be issued addressing replenishment items.

On June 2, 2000, the contracting officer at the Defense Supply Center Richmond awarded a requirements type contract to Honeywell for the initial 34 catalog items. The contract includes a base period of 3 years with two 3-year option periods. The contract also has award term provisions that allow the contractor to earn three

additional 1 year periods for a total possible contract length of 12 years. The estimated contract value is \$120 million. The contracting officer plans to add many more parts that DoD buys to the contract. The contract specifies direct vendor delivery of parts to DLA and its customers, and guarantees shipment within 15 days after electronic receipt of an order by Honeywell. The contract also requires 24-hour delivery when aircraft are grounded. Cost-based pricing was used in accordance with Honeywell's approved estimating system to determine fair and reasonable prices for the sole-source items. A commercial item determination was not made because of the limited effectiveness using a commercial pricing strategy in a sole-source market. Cost data (uncertified) was made available to and reviewed by representatives from the Defense Contract Audit Agency and the Defense Contract Management Agency to support cost realism. The Government agreed to perform a baseline analysis of the contractor's cost data only once, when an item is placed on the contract. In turn, Honeywell agreed to performance improvement savings (price reductions) totaling 10.5 percent starting the fourth year of the contract and continuing for a 6-year period. Prices for the first 3 years of the contract are fixed and represent a weighted average price that includes escalation. Prices for the next 6 years will be adjusted for escalation offset by the performance improvement savings, and prices for the last 3 years of the contract will be adjusted for escalation only.

The strategic supplier alliance catalog contract offers a positive opportunity for DLA and Honeywell by providing a significantly more efficient and economical procurement and management strategy for sole-source spare parts than earlier strategies. For the initial 34 items, shipment times will be reduced from a window of 20-25 days to less than 15 days and DLA inventory stock levels will be reduced from more than \$8 million to almost nothing. In addition, DLA customers' prices will be reduced between \$23 and \$40 million for CYs 2000 through 2011. In fact, DLA prices paid under its commercial contract in CY 1998 were higher than the catalog prices expected in CY 2011. The contract also provides Honeywell the opportunity to increase its return on investment. Also, both DoD and the contractor will realize procurement administrative savings because, instead of annually negotiating and procuring the items on different delivery order contracts, there will be only one negotiation and one contract. For details, see the Findings section of the report.

Management Comments. We provided a draft of this report on August 25, 2000. No written response was required, and none was received. Therefore, we are publishing the report in final form.

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Background

Spare Parts Audits. Over the past 4 years, the Office of the Inspector General, DoD, has worked closely with the Defense Logistics Agency (DLA) and other DoD Components to achieve fair pricing for sole-source items. We have issued a series of reports involving pricing of both commercial and noncommercial spare parts. Two of the reports addressed sole-source commercial and noncommercial spare parts procured from AlliedSignal Incorporated. In December of 1999 Allied Signal, Incorporated, and Honeywell, Incorporated, merged forming a new company, Honeywell International, Incorporated (Honeywell).

Report No. 99-026, "Commercial Spare Parts Purchased on a Corporate Contract," October 30, 1998. The audit showed that DLA supply centers paid AlliedSignal prices for commercial spare parts that were higher than fair and reasonable in FYs 1996 and 1997 when compared to the noncommercial prices paid to AlliedSignal in previous years. The audit determined that DLA paid a 54.5 percent premium for commercial parts from AlliedSignal. Included in the higher commercial prices were costs for AlliedSignal to manage, stock, and deliver the items directly to DoD users; which lowers the total ownership cost for the Government and allows DLA to take full advantage of AlliedSignal's commercial capabilities. In fact, effective implementation of the commercial buying practices and direct vendor delivery stipulated in the contract (SPO500-96-D-9502) would have helped offset the higher prices. Instead, DLA paid the premium and then purchased the parts for inventory and charged its customers the full cost recovery rates for inventory management and delivery of the items, thus increasing its customers' costs by \$3.2 million for FYs 1996 and 1997. The audit calculated that proper application of acquisition reform principles could reduce total ownership cost by at least \$12.5 million for FYs 1999 through 2004.

Report No. 99-218, "Sole-Source Noncommercial Spare Parts Orders on a Basic Ordering Agreement," July 27, 1999. The audit showed that DLA supply centers paid AlliedSignal prices that were higher than fair and reasonable. DLA supply centers paid about \$4.9 million (or 18 percent) more than fair and reasonable prices for the \$32.2 million of spare parts procured from AlliedSignal. The audit calculated that DLA supply centers could reduce total ownership costs for their customers by at least \$53.7 million during FYs 2000 through 2005 by using a combination of both cost- and price-based acquisition tools and negotiating a long-term commercial type contract with AlliedSignal.

DLA Price Trend for Commercial Items. In response to audit reports showing problems with prices for commercial items, DoD was required by Congress to prepare a report on price trends for commercial items. The "Report on Price Trend Analysis of Exempt Commercial Items," April 1, 2000, furnished in response to Subsection 803(c) of the Strom Thurmond National Defense Authorization Act for FY 1999 shows the overall price increases for commercial items purchased by DLA. The report shows that prices paid by DLA for sole-source commercial items had increased by 23 percent over a

6 year period from FY 1993 through FY 1999. In contrast, aggregate cost growth was slightly over 12.3 percent for the same period for all commercial items purchased by DLA.

Related Initiatives. Several DoD initiatives are in process relating to goods and services obtained from Honeywell. Often the initiatives overlap. The Navy and Air Force initiatives need to be carefully monitored by DoD because they may benefit the Services but not the overall DoD management of spare parts.

In June 1999, the Director, DLA and the Deputy Under Secretary of Defense (Acquisition Reform) chartered a rapid improvement team for the development of a new "Strategic Supplier Alliance" relationship between DLA and AlliedSignal (now Honeywell). The joint DoD/industry rapid improvement team developed a draft "Strategic Supplier Alliance Program Guidebook," October 13, 1999. The guidebook was designed to provide guidelines, processes, and rules of engagement for establishing and maintaining key supplier relationships to produce superior returns for both DoD and industry.

In October 1999, the Commander, Air Force Materiel Command, and the Deputy Under Secretary of Defense (Acquisition Reform) chartered a different Rapid Improvement Team for the development and deployment of a strategic supplier alliance with Honeywell. The strategic supplier alliance would result in an Air Force corporate contract with Honeywell for repair services as well as spare parts (reparable and consumable items).

In June 2000, the Naval Inventory Control Point, Philadelphia, awarded a contract to Honeywell for total logistics support of auxiliary power units of the P-3, C-2, S-3, and F/A-18 aircraft. About a third (11 items) of the consumable items included on the DLA catalog contract with Honeywell were also included on the Navy contract.

In July 2000, the Deputy Under Secretary of Defense (Acquisition Reform) convened a meeting with representatives from parts management communities of DoD, Boeing, and Honeywell to develop and test a new and better approach to parts management. The representatives agreed to move forward with another rapid improvement team campaign to jumpstart the development and acceptance of a "better, faster, cheaper" approach to parts management.

Objectives

The overall objective of this review was to analyze spare parts in the "catalog" and "replenishment" purchasing environments to identify key users and potential impediments and cost reductions associated with using these different environments to procure spare parts. Specific objectives focused on determining current logistics response times, stock levels, and potential cost reductions associated with shifting from the current method of support to a more tailored approach. See Appendix A for a discussion of the audit scope and methodology, and Appendix B for prior audit coverage related to the audit objectives.

Strategic Supplier Alliance for Catalog Items

The strategic supplier alliance contract for catalog items offers a positive opportunity for DLA and Honeywell by providing a significantly more efficient and economical procurement and management strategy for sole-source spare parts than earlier commercial contract or noncommercial order strategies. The contract for catalog items:

- provides improved logistics response times with shipment times reduced from 20-25 days to 15 days or less;
- enables DLA to reduce inventory from more than \$8 million to almost nothing;
- enables both DoD and Honeywell to realize procurement administrative savings because, instead of annually negotiating and procuring the items on different delivery order contracts, there is only one negotiation for each item on a single contract;
- provides Honeywell the opportunity to increase its return on investment by providing additional services and earning higher profits if costs can be reduced; and
- provides DLA customers with lower stabilized prices for the next 12 years. In fact, the CY 1998 commercial prices were \$40.31 million (or 51.1 percent) higher and the CY 2000 noncommercial prices were \$22.62 million (or 28.7 percent) higher than the catalog contract prices for CYs 2000 through 2011.

Strategic Supplier Alliance

Rapid Improvement Team. In June 1999, the Deputy Under Secretary of Defense (Acquisition Reform) and the Director, DLA chartered the development and deployment of a pilot program to test the framework and tools for improving the total value for military customers and industry stockholders.

The strategic supplier alliance employed a rapid improvement team (RIT) as the catalyst to drive the development and execution of plans designed to improve the total DoD supplier relationship. The RIT, facilitated by a representative from Leap Technologies, is an integrated process team with short timeframes set for the accomplishment of established goals. The RIT included representatives from Honeywell; DLA; Defense Procurement; the Defense Contract Audit Agency (DCAA); the Defense Contract Management Agency (DCMA); the Office of General Counsel; the Office of the Inspector General, DoD; and the Under Secretary of Defense (Acquisition Reform). The RIT also included

representatives from the Army, Navy, and Air Force. Numerous RIT meetings were convened to develop a guide and execution plan for the strategic supplier alliance between DLA and Honeywell.

Demand Environment Map. Instead of trying to use a "one size fits all" approach to a procurement strategy, the RIT used an approach recommended by the facilitator that sorted items based on the nature of the demand for different customers and the supplier economics of responding to those demands. Customer demands represent the order size and frequency as well as the predictability of the demand. A demand environment map was employed which became the cornerstone for the alliance relationship and the catalyst for moving from a transaction-based approach to contracting to a strategic alliance approach. In essence, demand and purchasing requirements were matched with supplier capabilities to leverage buying power and improve production economies of scale. For example, those items with stable demand and multiple customers (five or more) fell into the "catalog demand" environment. Those items with stable demand and one dominant customer fell into the "replenishment demand" environment and those items with unstable demand fell into either the "rapid response" or "build to order" demand environments.

As the DLA/Honeywell RIT evolved, it was determined that three separate contracts would be required, one for each of the purchasing demand environments. Build to order and rapid response items were determined to be similar enough to be purchased on the same contract, while separate contracts were required for catalog and replenishment demand items.

Figure 1 shows the purchasing demand environment map employed by the DLA/Honeywell RIT and the characteristics for each environment.

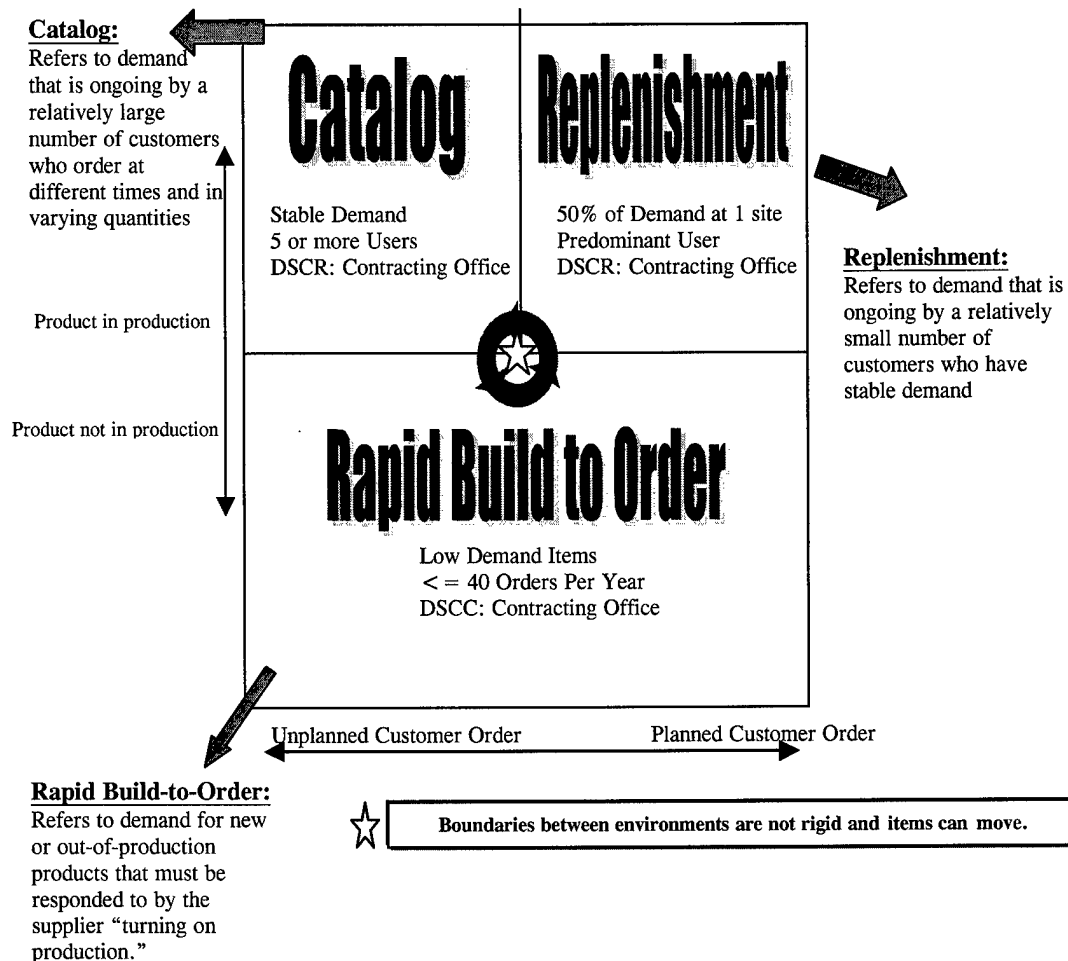


Figure 1. Purchasing Demand Environment Map

Pricing Matrix Model. The RIT also devoted significant efforts to evaluating alternative pricing approaches and to developing a pricing model matrix. The pricing model matrix details how various pricing approaches work, the advantages and disadvantages, and when to best apply each approach.

Figure 2 shows the pricing model matrix and various pricing approaches (also from the strategic supplier alliance program guidebook).

Pricing Approach	Cost Build-Up	Historical--Plus	Competitive Bid	Market Price
How it works	Supplier's best forecast of actual costs. DoD audits/profit negotiated	DoD and supplier agree on baseline price using historical data/adjustments made as terms change	DoD issues RFP to market, supplier bids the price	DoD establishes a target price based on a "comparison" to like or closely similar products
Advantages	Reduces risks for both DoD and supplier on new, high-dollar value products and for items where there is no competition or a market	Fast and easy approach to adjusting prices on products where terms are favorable	Maintains "open and fair" policy within alliance framework, motivates key suppliers to continually improve	Maintains high level of price integrity, provides lower acquisition costs over time. Lower supplier administration costs
Dis advantages	Higher administrative costs can provide disincentives to supplier to lower costs over time	Compounding risk if baseline price is not an accurate representation of product value	High administrative costs can result in poor decisions if DoD and suppliers lack experience in the product up for bid	High research costs can destabilize the supplier
How/ When to Apply it Best	Use for Sole Source items Audit costs once to establish baseline	Use for products which need variable pricing and terms to fit demand environment. Establish baseline price using historical cost/price data Set future price targets for supplier	Use primarily for products moving from sole source to competitive category Establish clear product specifications and supplier evaluation criteria Select supplier based on best value	Use for "commodity" like products where comparison shopping is relatively easy to execute and a market exists Agree with supplier on frequency of price reviews Establish upper/lower limits for price adjustments

Figure 2. Pricing Model Matrix

In regard to the DLA/Honeywell strategic alliance, the RIT determined that since all the items were considered sole-source using competitive pricing was not an option. Also, using market (commercial) pricing would not be practical because there really was no commercial market to compare like or closely similar products to establish baseline prices with a high level of confidence. A high level of confidence in pricing was necessary due to the potential length of the contract (12 years); therefore, reducing risk was key to any pricing approach. Accordingly, the RIT decided on the cost build-up approach where Honeywell would use cost-based pricing in accordance with its approved estimating system to price items. Cost data (uncertified) was made available and reviewed by representatives from DCAA and the DCMA to support cost realism. The Government agreed to perform an analysis of the contractor's cost

data only once, when an item is placed on the contract. In turn, Honeywell agreed to share-in-savings price reductions totaling 10.5 percent (catalog contract) starting the fourth year of the contract and continuing for a 6-year period.

Contract Type

Catalog Contract. On June 2, 2000, the contracting officer at DSCR awarded a requirements type contract to Honeywell for the first 34 catalog items. The contract has a base period of 3 years with two 3-year option periods. The contract also has award term provisions that allow the contractor to earn three additional 1-year periods for a total possible contract length of 12 years. The estimated contract value is \$120 million. The contracting officer plans on adding many more parts from all of DoD to the contract. The Government plans to measure the contractor's performance against stated quality and delivery metrics contained in the contract. If the contractor exceeds the performance criteria, then the Government will award the contractor additional years of performance under the contract.

The catalog contract was basically a "hybrid" using both Federal Acquisition Regulation (FAR) Part 12, "Acquisition of Commercial Items," and FAR Part 15, "Contracting by Negotiation" clauses as determined appropriate. Items were not classified as commercial; however, cost or pricing data (certified) was waived in return for access to the cost data used by Honeywell to price the parts. In addition, other clauses were waived that were duplicative in nature or created the same results. Use of this approach made it necessary for the DSCR contracting officer to obtain a waiver from FAR provisions.

Honeywell Position on Cost Accounting Standards (CAS). Honeywell had stated that it would not accept a CAS covered contract under the strategic supplier alliance for both military unique and commercial items because the nature of the teaming arrangement is commercial. For the same items, the practice before the catalog contract was to issue individual purchase/delivery orders for each part number. This required order-by-order negotiations of price and contract terms and significantly longer administrative lead times for delivery. Honeywell stated that since January 1, 1998, Honeywell's Defense and Space Division had received approximately 10,629 individual military purchase/delivery orders from DLA and that only 25 (or 0.2 percent) had included the CAS clause. This was because the delivery orders were usually under \$500,000. Therefore, the DoD did not give up much by granting the CAS waiver.

CAS Waiver. On May 26, 2000, the Under Secretary of Defense for Acquisition Technology and Logistics waived the CAS requirements for the catalog contract with Honeywell. The Under Secretary commented that the CAS waiver would facilitate civil-military integration by permitting DLA to enter into a pilot strategic supplier alliance with Honeywell that would test Honeywell's commercial supply methodology in the DoD marketplace.

Logistics Response Time Goals

The catalog contract requires improved delivery over current DLA performance and DoD goals. The catalog contract is for direct vendor delivery of parts to DLA customers, with guaranteed shipment within 15 days (although normal delivery will be within a few days) after electronic receipt of an order by Honeywell. The contract also requires 24 hour delivery when aircraft are grounded. The Defense Supply Center Richmond (DSCR) reported that for RIT candidate items, the average wait time for the past year was 23 days (time from receipt of a requisition to the time the depot ships the item) and that 8 percent of the requisitions were not filled within 90 days. The Government Performance and Results Act (FY 2000 Performance Plan) shows a logistics response time baseline of 35 days in FY 1997 and goals of 24 and 18 days for FYs 1999 and 2000, respectively. Logistics response time is the elapsed time (in days) from customer requisition to receipt of material ordered from the DoD wholesale system. We also reviewed logistics response times for 18 different catalog customers (1,122 requisitions) and found the average logistics response time (from the depot) to be 29.9 days (median 8 days). Although the catalog contract does not provide a direct comparison to logistics response time, the improvements in days from receipt of an order to item shipment should translate to improved logistics response times. For each day logistics response time is reduced, retail costs are reduced because fewer parts are needed in inventory.

Supply Inventory

If properly used, the catalog contract will reduce DoD supply inventory. The Government Performance and Results Act (FY 2000 Performance Plan) shows a goal to reduce supply inventory from a FY 1989 high of \$107 billion to \$48 billion by FY 2003. As of July 1999, DLA had \$8,348,948 of wholesale inventory (on-hand plus due-ins, less backorder items) for the 34 national stock numbers (NSNs) on the catalog contract. The wholesale inventory figure represented a little more than 150 percent of the value of the annual requirement for the items. Over the next few years, DSCR plans on reducing wholesale inventory for the catalog items to almost nothing. About 5 or 10 percent of the current level will be maintained, primarily to satisfy requirements for foreign military sales. In addition, for the items reviewed, the catalog customers maintained a retail inventory of 21.5 percent of the amount requisitioned. The retail inventory maintained by DLA customers relates directly to the DLA logistics response time. For example, the longer it takes for a customer to receive an item the more retail inventory that customer must maintain. Improvements in logistics response times should also help reduce retail inventory maintained by DLA customers.

Administrative Procurement Costs

Both DoD and the contractor will realize administrative savings. Instead of annually negotiating and procuring the items on different delivery order contracts, DLA and Honeywell will negotiate a price for each item a single time on a single contract. Negotiated prices (adjusted for inflation and performance improvement) will be good for the life of the contract. Since 1996, DLA has averaged about one procurement per year for each of the items on the catalog contract. DORRA has calculated that the average cost for a DoD inventory control point to procure an item is about \$160 for small buys (under \$100,000) and somewhere between \$1,600 and \$12,000 for large buys (over \$100,000).

Improved Supplier Satisfaction

The strategic supplier alliance contract provides Honeywell the opportunity to increase its return on investment by providing additional services and earning higher profits if costs can be reduced. The catalog contract includes a catalog service fee of [REDACTED]. The catalog service fee is considered a commercial service for shipping, forecasting, maintaining inventory and other catalog related services. Honeywell did not provide cost data in support of the catalog service fee. However, the catalog service fee is in line with the DSCR surcharge for similar services. The DSCR surcharge is significantly less when items are procured using direct vendor delivery (about 7 percent) versus procured for stock in DLA depots (about 30 percent). The catalog contract prices are also fixed for an extended period in accordance with the terms of the contract, enabling Honeywell to earn higher profits if costs can be reduced.

Customer Prices for Catalog Items

Catalog Demand Pricing Methodology. The pricing methodology for the contract requires that cost-based pricing be used in accordance with Honeywell's approved estimating system. As stated earlier, Honeywell provided DLA with a price list and made cost data (uncertified) available to the cognizant DCAA and DCMA offices to support cost realism.

Table 1 shows prior year prices for the initial 34 catalog items and prices under the recently negotiated catalog contract.

Table 1. Prior Year Prices and Annual Prices for Catalog Contract Items (\$millions)								
DSCR and Honeywell Contract Adjustments								
CY	Annual Cost	Escalation (percent)	Price Performance (percent)	Net Adjustment	Subtotal			Annual Customer Price
1996	\$6.15							\$7.99
1997	5.47							7.11
1998	6.02							7.82
1999	5.52							7.17
2000	5.44							7.07
Prior Year								
2000	4.69							6.17
2001	4.69							6.17
2002	4.69							6.17
2003	4.69	3.3	(3.0)	0.3	\$4.70			6.19
2004	4.70	3.5	(2.5)	1.0	4.75			6.25
2005	4.75	3.2	(2.0)	1.2	4.81			6.33
2006	4.81	3.3	(1.5)	1.8	4.89			6.44
2007	4.89	3.4	(1.0)	2.4	5.01			6.60
2008	5.01	3.3	(0.5)	2.8	5.15			6.78
2009	5.15	3.3		3.3	5.32			7.01
2010	5.32	3.3		3.3	5.50			7.24
2011	5.50	3.3		3.3	5.68			7.48
Catalog Contract								
Total		29.9	(10.5)	19.4				\$78.83*

*Total represents catalog contract only and does not include prior year prices.

During CYs 1996, 1997, and 1998 orders for 15, 18, and 21 of the NSNs on the catalog contract were placed on the Defense Supply Center Philadelphia commercial contract (SPO500-96-D-9502). Orders for the catalog items in CYs 1999 and 2000 were placed on other noncommercial contracts. Appendix C, "CYs 1998 and 2000 Costs and Catalog Demand Prices," shows a price comparison by NSN.

Prior Year Commercial and Noncommercial Prices. Both the commercial and noncommercial prices paid by DLA customers were significantly higher than prices customers will pay under the catalog contract. As reported in Audit Report No. 99-026, DLA supply centers issued delivery orders totaling over \$25 million in FYs 1996 and 1997 to Honeywell (formerly Allied Signal Incorporated) on corporate contract SPO500-96-D-9502. The DLA supply centers used the contract to purchase spare parts that were commercial catalog items such as gearshafts, wheels, nuts, bearings, seals, filters, and valves. The

Defense Supply Center Philadelphia negotiated the contract prices based on a discount from the contractor's commercial catalog price. As part of the justification for the reasonableness of contract prices, the contracting officer included production lead-time savings associated with the contractor maintaining and distributing inventory. The savings ranged from 20 to 40 percent of the item acquisition cost. Although the contract was intended to provide direct vendor delivery of supplies from the contractor to DLA customers; DLA supply centers failed to implement procedures to use direct vendor delivery. Instead, DLA procured items for its inventory and stocked the Defense depots. This occurred because the delivery times for a significant number of items published in the contractor's catalog were in excess of 20 days—the time necessary to meet DLA direct vendor delivery requirements. During the audit, the DSCR contracting officer obtained price concessions for three NSNs on the contract where the reasonableness of the commercial price was questioned. After the problems with the commercial contract were identified, orders placed for the catalog items in CYs 1999 and 2000 were made on other noncommercial contracts.

Table 2 shows that escalated CY 1998 commercial prices are \$40.31 million (or 51.1 percent) higher than the catalog prices, and the escalated CY 2000 noncommercial prices are \$22.62 million (or 28.7 percent) higher than the catalog prices. Escalation percentages used in the contract are from the Data Resource Institute projections.

Table 2. Comparison of Catalog Demand Contract Prices with Prior Year Commercial and Noncommercial Prices (\$ millions)

CY	Catalog Demand Prices	Escalated Prices	
		CY 1998 Commercial Prices	CY 2000 Noncommercial Prices
1998		\$7.82	
1999		8.11	
2000	\$6.17	8.31	\$7.07
2001	6.17	8.55	7.28
2002	6.17	8.79	7.48
2003	6.19	9.08	7.73
2004	6.25	9.40	8.00
2005	6.33	9.70	8.26
2006	6.44	10.02	8.53
2007	6.60	10.36	8.82
2008	6.78	10.70	9.11
2009	7.01	11.05	9.41
2010	7.24	11.42	9.72
2011	7.48	11.79	10.04
Total	\$78.83	\$119.14	\$101.45
Difference from catalog contract		\$40.31	\$22.62
Percent difference		51.1	28.7

Figure 3 shows a comparison of the commercial prices, noncommercial prices, and the catalog demand prices.

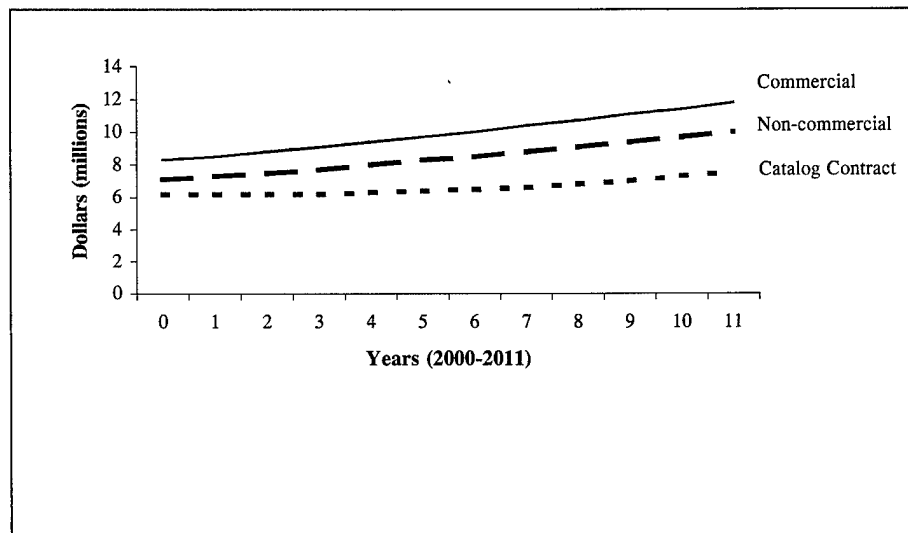


Figure 3. Commercial and Noncommercial Contract Prices Are Significantly Higher Than Catalog Prices

Conclusion

DoD has initiated several innovative purchasing approaches in the acquisition reform environment that involve commercial pricing, price-based acquisition, prime vendors, and total logistics support. Evaluating empirical results and determining which of these approaches offer the best models for future DoD procurement efforts remain as important challenges.

The strategic supplier alliance contract with Honeywell for catalog demand items clearly provides a positive opportunity for both DoD and Honeywell. The catalog contract improves logistics response times, enables DLA to reduce inventory, provides Honeywell the opportunity to increase its return on investment, and provides DLA customers with lower stabilized prices. In fact, DLA prices paid under its commercial contract in CY 1998 were higher than the catalog prices expected for purchases in CY 2011.

Appendix A. Audit Process

Scope and Methodology

Work Performed. For the initial 34 NSNs on the catalog contract, we reviewed requisition data from 1998 and 1999 supplied by the Defense Operations Research and Resource Analysis office (DORRA) to identify the number of different users for the same parts and the annual demand. We reviewed procurement history reports covering the past 14 years to determine the stability of demand and to validate the annual demand for parts. We also used the procurement history reports to calculate annual prices for CYs 1996 through 2000. The escalation figures used in the contract from the Data Resource Institute were used to calculate future year prices. We also obtained information from DORRA relating to on-hand inventory, items due in and items on backorder to calculate DLA inventory levels and the value of the inventory. We reviewed cost data provided by Honeywell and discussed the data with the DSCR contracting officer and cost analysis representatives. We also reviewed the contract, CAS waiver, and other contract documentation.

DoD-Wide Corporate Level Government Performance and Results Act (GPRA). In response to the GPRA, the Secretary of Defense annually establishes DoD-wide corporate level goals, subordinate performance goals, and performance measures. This report pertains to achievement of the following goal, subordinate performance goals, and performance measures:

FY 2000 DoD Corporate Level Goal 2: Prepare now for an uncertain future by pursuing a focused modernization effort that maintains U.S. qualitative superiority in key warfighting capabilities. Transform the force by exploiting the Revolution in Military Affairs, and reengineer the Department to achieve a 21st century infrastructure. (00-DoD-2)
FY 2000 Subordinate Performance Goal 2.3: Streamline the DoD infrastructure by redesigning the Department's support structure and pursuing business practice reforms. (00-DoD-2.3) **FY 2000 Performance Measure 2.3.1:** Percentage of the DoD Budget Spent on Infrastructure. (00-DoD-2.3.1) **FY 2000 Performance Measure 2.3.2;** Unfunded Depot Maintenance Requirements (\$ in Millions). (00-DoD-2.3.2) **FY 2000 Performance Measure 2.3.4;** Logistics Response Time. (00-DoD-2.3.4) **FY 2000 Performance Measure 2.3.6;** Disposal of Excess National Defense Stockpile (NDS) Inventory and Reduction of Supply Inventory (\$ in Billions). (00-DoD-2.3.6) **FY 2000 Performance Measure 2.3.8;** Defense Working Capital Fund (DWCF) Net Operation Results (\$ in Millions). (00-DoD-2.3.8) **FY 2000 Subordinate Performance Goal 2.4:** Meet combat forces' needs smarter and faster, with products and services that work better and cost less, by improving the efficiency of DoD acquisition processes. (00-DoD-2.4) **FY 2000 Performance Measure 2.4.6:** Reductions in the Acquisition Workforce (In percents). (00-DoD-2.4.6).

DoD Functional Area Reform Goals. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objectives and goals.

- **Acquisition Functional Area. Objective:** Internal reinvention. **Goal:** Dispose of \$2.2 billion in excess National Defense Stockpile inventories and \$3 billion in unneeded Government property while reducing supply inventory by \$12 billion. (ACQ-3.3)
- **Logistics Functional Area. Objective:** Reduce logistics cycle times. **Goal:** Reduce average logistics response times by 1/3 by 9/97 (based on 1st QTR FY 1996 averages) and reduce average age of backordered items to 30 days by 10/01. (LOG-1.1)
- **Logistics Functional Area. Objective:** Streamline logistics infrastructure. **Goal:** Implement most successful business practices (resulting in reductions of minimally required inventory levels). (LOG-3.1)

Use of Computer-Processed Data. To achieve the audit objectives, we relied on computer-processed data from DLA and commercial sources. We queried the DLA Standard Automated Material Management System to determine requisition data and inventory levels of consumable items that are managed by DLA. We also obtained procurement history information from a commercial system, "Haystack Online for Windows" provided by Information Handling Services, Engineering Products Division. The computer-processed data were determined reliable based on results of recent spare parts audits at DLA. Nothing came to our attention as a result of specified procedures that caused us to doubt the reliability of the computer processed data.

Audit Type, Dates, and Standards. We performed this program audit from September 1999 through July 2000 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. Audit team members that prepared this report and related Report Numbers 99-026 and 99-218, also participated as team members on the DLA/Honeywell rapid improvement team.

Contacts During the Audit. We visited or contacted individuals within the DoD and Honeywell. Further details are available on request.

Appendix B. Prior Coverage

During the last 5 years, the General Accounting Office has issued three audit reports and the Inspector General, DoD, has issued seven audit reports discussing either prices for spare parts or Defense inventory management in the acquisition reform environment.

General Accounting Office

General Accounting Office Report No. NSIAD-00-22 (OSD Case No. 1903), "Contract Management: A Comparison of DoD and Commercial Airline Purchasing Practices," November 29, 1999.

General Accounting Office Report No. NSIAD-00-1 (OSD Case No. 1885), "Defense Inventory: Improved Management Framework Needed to Guide Navy Best Practice Initiatives," October 21, 1999.

General Accounting Office Report No. NSIAD-99-90 (OSD Case No. 1808), "DoD Pricing of Commercial Items Needs Continued Emphasis," June 24, 1999.

Inspector General, DoD

Inspector General, DoD, Report No. D-2000-099, "Procurement of the Propeller Blade Heaters for the C-130 and P-3 Aircraft," March 8, 2000*

Inspector General, DoD, Report No. D-2000-098, "Spare Parts and Logistics Support Procured on a Virtual Prime Vendor Contract," March 8, 2000*

Inspector General, DoD, Report No. 99-218, "Sole-Source Noncommercial Spare Parts Orders On a Basic Ordering Agreement," July 27, 1999.*

Inspector General, DoD, Report No. 99-217, "Sole-Source Commercial Spare Parts Procured on a Requirements Type Contract," July 21, 1999.*

Inspector General, DoD, Report No. 99-026, "Commercial Spare Parts Purchased on a Corporate Contract," October 30, 1998.*

*Only redacted versions of these reports will be available on the internet at www.dodig.osd.mil/audit/reports.

Inspector General, DoD, Report No. 98-088, "Sole-Source Prices for Commercial Catalog and Noncommercial Spare Parts," March 11, 1998.*

Inspector General, DoD, Report No. 98-064, "Commercial and Noncommercial Sole-Source Items Procured on Contract N000383-93-G-M111," February 6, 1998.*

*Only redacted versions of these reports will be available on the internet at www.dodig.osd.mil/audit/reports.

Appendix C. CYs 1998 and 2000 Costs and Catalog Demand Prices

NSN	Annual Quantity	Unit Cost		Catalog Demand Unit Price	Annual Cost		Catalog Demand Annual Price
		CY 1998*	CY 2000		CY 1998	CY 2000	
	376	\$250.29	\$244.53	\$290.20	\$94,109	\$91,943	\$109,115
	266	218.60	419.53	432.24	58,148	111,595	114,976
	61	1,898.85	2,191.05	2,638.86	115,830	133,654	160,970
	363	758.04	1,010.75	962.58	275,169	366,902	349,417
	194	76.50	121.29	177.64	14,841	23,530	34,462
	67	467.10	467.00	144.70	31,296	31,289	9,695
	213	39.60	35.00	54.74	8,435	7,455	11,660
	291	275.85	163.94	181.87	80,272	47,707	52,924
	62	2,714.20	2,714.20	2,816.78	168,280	168,280	174,640
	197	12.97	12.97	23.38	2,555	2,555	4,606
	69	2,677.95	2,389.72	2,613.37	184,779	164,891	180,323
	67	2,129.40	1,511.07	1,582.62	142,670	101,242	106,036
	40	2,991.26	2,774.56	3,205.55	119,650	110,982	128,222
	55	5,609.70	3,069.80	3,522.90	308,534	168,839	193,760
	297	6,350.00	6,350.00	7,062.41	1,885,950	1,885,950	2,097,536
	128	45.90	31.00	93.78	5,875	3,968	12,004
	144	4,361.40	3,064.84	3,046.69	628,042	441,337	438,723
	71	2,503.34	2,686.70	3,275.45	177,737	190,756	232,557
	32	7,192.13	2,786.93	2,573.19	230,148	89,182	82,342
	45	2,578.00	2,882.67	3,095.63	116,010	129,720	139,303
	168	936.45	657.23	770.17	157,324	110,415	129,389
	143	179.10	384.59	248.44	25,611	54,996	35,527
	48	831.37	831.37	717.04	39,906	39,906	34,418
	52	3,944.70	2,112.93	1,624.76	205,124	109,872	84,488
	217	798.75	408.99	482.60	173,329	88,751	104,724
	253	51.75	66.00	83.19	13,093	16,698	21,047
	258	176.85	228.95	210.85	45,627	59,069	54,399
	248	763.65	763.65	580.05	189,385	189,385	143,852
	284	332.55	420.00	520.23	94,444	119,280	147,745
	98	990.00	990.00	1,032.08	97,020	97,020	101,144
	40	764.78	1,238.03	1,315.07	30,591	49,521	52,603
	734	128.70	67.93	73.63	94,466	49,861	54,044
	263	343.58	272.71	168.79	90,362	71,723	44,392
	44	2,569.58	2,569.58	2,903.65	113,062	113,062	127,761

Total

\$6,017,674 \$5,441,336 \$5,768,804

*21 bold figures represent commercial prices.

Appendix D. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Technology, and Logistics
Deputy Under Secretary of Defense (Acquisition Reform)
Deputy Under Secretary of Defense (Logistics)
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Director, Defense Procurement
Under Secretary of Defense (Comptroller)
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Department of the Navy

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Commander, Naval Supply Systems Command
Commander, Naval Inventory Control Point

Department of the Air Force

Assistant Secretary of the Air Force (Acquisition)
Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Contract Management Agency

Other Defense Organizations (cont'd)

Director, Defense Logistics Agency
Commander, Defense Supply Center Columbus
Commander, Defense Supply Center Richmond
Commander, Defense Supply Center Philadelphia

Non-Defense Federal Organizations

Office of Management and Budget
Technical Information Center, National Security and International Affairs Division,
General Accounting Office

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Management, Information, and Technology,
Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International
Relations, Committee on Government Reform

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